

REPORT OF EXAMINATION
OF THE
NORCAL MUTUAL INSURANCE COMPANY

AS OF
DECEMBER 31, 2008

Participating State
and Zone:

California

Filed December 14, 2009

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San Francisco, California
November 18, 2009

Honorable Alfred W. Gross
Chairman of the NAIC Financial
Condition (EX4) Subcommittee
Commissioner of Insurance
Virginia Bureau of Insurance
Richmond, Virginia

Honorable Morris Chavez
Secretary, Zone IV-Western
Superintendent of Insurance
New Mexico Insurance Division
Santa Fe, New Mexico

Honorable Steve Poizner
Insurance Commissioner
California Department of Insurance
Sacramento, California

Dear Chairman, Secretary and Commissioner:

Pursuant to your instructions, an examination was made of the

NORCAL MUTUAL INSURANCE COMPANY

(hereinafter also referred to as the Company) at its home office, located at 560 Davis Street, Suite 200, San Francisco, California 94111.

SCOPE OF EXAMINATION

The previous examination of the Company was made as of December 31, 2004. This examination covers the period from January 1, 2005 through December 31, 2008. The examination was conducted pursuant to the National Association of Insurance Commissioners' plan of examination. The present examination included a review of the Company's practices and procedures, an examination of management records, tests and analyses of detailed transactions, an evaluation of assets, and a determination of liabilities as of December 31, 2008, as deemed necessary under the circumstances. The examination was conducted concurrently with the examination of the Company's subsidiary PMSLIC Insurance Company, a Pennsylvania domiciled company.

In addition to those items specifically commented upon in this report, other phases of the Company's operations were reviewed including the following areas that require no further comment: company history; corporate records; fidelity bonds and other insurance; officers', employees' and agents' welfare and pension plans; growth of company; business in force by states; loss experience; accounts and records; and sales and advertising.

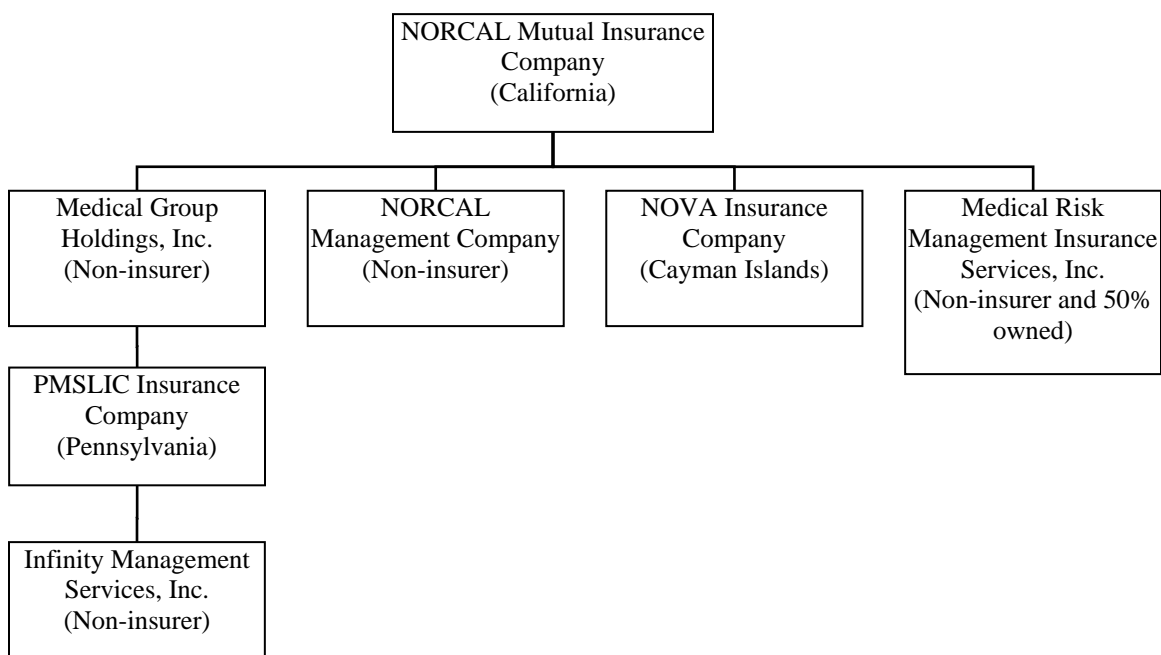
SUBSEQUENT EVENTS

Effective January 2009, the Company and its subsidiary, PMSLIC Insurance Company (PMSLIC), underwent a reorganization which included appointing new directors, the creation of a chief operating officer position, addressing staffing redundancies through a reduction in workforce, and the streamlining of information technology systems. Both companies now have common executive officers, directors, and committees.

The Company's wholly owned subsidiary NOVA Insurance Company was dissolved on September 30, 2009 and another subsidiary, Medical Group Holdings, Inc. (MGH) was dissolved on October 9, 2009. Effective with MGH's dissolution, PMSLIC became a direct subsidiary of the Company.

MANAGEMENT AND CONTROL

The Company is a member of an insurance holding company system which includes a Pennsylvania insurer and a Cayman Island insurer. The following organization chart depicts the interrelationship of the companies within the holding company system as of December 31, 2008 (all ownership is 100% unless otherwise indicated):



Management of the Company is vested in a nine-member board of directors who are elected for a term of three years. As of December 31, 2008, the directors and principal officers were as follows:

Directors

| <u>Name and Residence</u> | <u>Principal Business Affiliation</u> |
|--|---|
| Patricia A. Dailey, M.D. Hillsborough, California | Physician |
| Candace L. Dyer, M.D. Warwick, Rhode Island | Physician |
| Steven S. Fountain, M.D. LaQuinta, California | Physician |
| Roger M. Hayashi, M.D. Los Gatos, California | Physician |
| David R. Holley, M.D. Carmel, California | Chairman NORCAL Mutual Insurance Company |

Directors (continued)

| <u>Name and Residence</u> | <u>Principal Business Affiliation</u> |
|---|---|
| Walter J. MacGinnitie Atlanta, Georgia | Actuary and Consultant |
| Harry B. Richardson, M.D. Santa Rosa, California | Physician |
| Michael D. Stephens Newport Beach, California | Hospital Administrator Hoag Memorial Hospital Presbyterian |
| William R. Vetter, M.D. Carmichael, California | Physician |

Principal Officers

| <u>Name</u> | <u>Title</u> |
|------------------------|--|
| James Sunseri | President and Chief Executive Officer |
| Michael L. Pautler | Senior Vice President and Chief Financial Officer |
| Katherine H. Crocker | Senior Vice President, Chief Legal Officer and Secretary |
| Daniel A. Corrado | Senior Vice President, Insurance Operations |
| Stephen M. Farber | Vice President, Risk Management |
| Paul R. Gabel | Vice President, Claims |
| Mark L. Gire | Vice President, Information Technology |
| Philip R. Hinderberger | Senior Vice President, Government and Regulatory Affairs |
| John E. McClain | Vice President, Human Resources |
| Sharon A. Mullen | Vice President, Finance and Controller |
| Jane M. Tishkoff | Associate Vice President and Assistant General Counsel |
| Bruce P. Williams | Associate Vice President, Actuarial |

Intercompany Agreements

Effective January 1, 2009, the Company entered into an intercompany affiliated service agreement with PMSLIC Insurance Company (PMSLIC). Under the terms of this agreement,

both companies may share in and use the services of personnel and facilities of the other in carrying out the NORCAL Group's business. The services rendered under this agreement may include accounting, taxes, and auditing; underwriting; claims; investment; and functional support services. Compensation for the services is based on the actual cost. Indirect and shared expenses are allocated in accordance with a method of cost allocation in conformity with Statements of Statutory Accounting Principles No. 70. Pursuant to California Insurance Code (CIC) Section 1215.5(b)(4), this agreement was submitted and approved by the California Department of Insurance (CDI) on September 4, 2009.

Effective January 1, 2000, the Company entered into a cost sharing agreement with NORCAL Management Company (NMC) for the sharing of certain administrative services and facilities. The charges or fees for the services or facilities are to be the ordinary, fair and reasonable cost without profit. Pursuant to CIC Section 1215.5(b)(4), this agreement was submitted and approved by the CDI on January 7, 2002.

Effective December 31, 2002, the Company entered into a tax allocation agreement with subsidiaries NMC, Medical Group Holdings, Inc. (MGH), PMSLIC, and Infinity Management Services, Inc. in which the tax liability is allocated proportionally based upon each subsidiary's separate tax return calculations. With the dissolution of MGH, it is recommended that the Company amend this agreement and file it with the CDI pursuant to CIC Section 1215.5(b)(4).

TERRITORY AND PLAN OF OPERATION

As of December 31, 2008, the Company was licensed in Alaska, Arizona, California, Connecticut, the District of Columbia, Massachusetts, Nevada, New Jersey, New Mexico, Oregon, Pennsylvania, and Rhode Island. The Company is also an authorized reinsurer in Maryland.

The majority of business is written in California where the Company is licensed to write fire, marine, plate glass, liability, boiler and machinery, burglary, sprinkler, team and vehicle, automobile, and miscellaneous. Of the \$183 million in direct premiums written in 2008, 89%

was written in California, 8% in Rhode Island, and the remaining 3% was written in Alaska, Arizona, and New Mexico.

The Company issues professional and premises liability to physicians, medical groups and hospitals on a claims-made basis. Tail coverage (including death, disability, and retirement) is offered as well and is issued on an occurrence basis. Business is written both directly and through independent brokers. Underwriting is performed and policy files are kept at the home office in San Francisco, California. Claims are handled at the home office and the district offices in Pasadena, California, Providence, Rhode Island and Anchorage, Alaska.

REINSURANCE

Pooling

Effective January 1, 2007, the Company entered into a pooling agreement with its wholly-owned subsidiary, PMSLIC Insurance Company (PMSLIC). Under the terms of this agreement, the Company is the lead company and assumes 100% of PMSLIC's net business. The Company retains 73% of the pooled business and cedes 27% back to PMSLIC. The pooling agreement was approved by the California Department of Insurance on March 6, 2007. Assumed premiums under this agreement during 2008 were \$75.8 million and consisted of medical malpractice – claims made and occurrence business written in the states of Pennsylvania and Delaware.

Assumed

The Company had no material assumed reinsurance during the examination period other than from the pooling agreement discussed above.

Ceded

The following table is an outline of the Company's ceded reinsurance program as of December 31, 2008:

| <u>Type of Contract</u> | <u>Reinsurer</u> | <u>Company's Retention</u> | <u>Reinsurer's Maximum Limit</u> |
|--|---|-------------------------------|--|
| Excess of Loss (California hospital systems only) | General Reinsurance Corp | \$2 million per occurrence | \$15 million excess of \$2 million per occurrence |
| Excess of Loss | Hannover Reinsurance (Ireland) Ltd. – 75% Aspen Insurance Limited – 25% | \$2 million per occurrence | \$20 million excess \$2 million per occurrence |

In addition, the Company secures facultative coverage for policies which do not meet the conditions of either of the above treaties.

FINANCIAL STATEMENTS

The financial statements prepared for this examination report include:

Statement of Financial Condition as of December 31, 2008

Underwriting and Investment Exhibit for the Year Ended December 31, 2008

Reconciliation of Surplus as Regards Policyholders from December 31, 2004 through
December 31, 2008

Statement of Financial Condition
as of December 31, 2008

| | <u>Ledger and Non-ledger Assets</u> | <u>Non- Admitted Assets</u> | <u>Net Admitted Assets</u> | <u>Notes</u> |
|---|---|-------------------------------------|------------------------------------|--------------|
| <u>Assets</u> | | | | |
| Bonds | \$ 574,791,646 | \$ | \$ 574,791,646 | |
| Preferred stocks | 3,710,755 | | 3,710,755 | |
| Common stocks | 324,260,563 | | 324,260,563 | (1) |
| Cash and short-term investments | 39,899,360 | | 39,899,360 | |
| Other invested assets | 29,560,436 | | 29,560,436 | |
| Aggregate write-ins for invested assets | 13,577,669 | | 13,577,669 | |
| Investment income due & accrued | 7,511,283 | 15,147 | 7,496,136 | |
| Premiums and agents' balances: | | | | |
| In course of collection | 20,832 | 20,832 | 0 | |
| Booked but deferred and not yet due | 20,634,730 | | 20,634,730 | |
| Reinsurance recoverables | 13,205,425 | | 13,205,425 | |
| Federal income tax recoverable | 11,073,685 | | 11,073,685 | |
| Net deferred tax asset | 36,252,928 | 15,811,041 | 20,441,887 | |
| Electronic data processing equipment and software | 876,561 | 367,395 | 509,166 | |
| Furniture and equipment | 1,442,303 | 1,442,303 | 0 | |
| Receivable from parent, subsidiaries and affiliates | 776,500 | | 776,500 | |
| Aggregate write-ins for other than invested assets | <u>3,990,853</u> | <u>3,635,191</u> | <u>355,662</u> | |
| Total assets | <u>\$1,081,585,529</u> | <u>\$ 21,291,909</u> | <u>\$1,060,293,620</u> | |
| <u>Liabilities, Surplus and Other Funds</u> | | | | |
| Losses | | | \$ 305,960,810 | (2) |
| Reinsurance payable on paid losses and loss adjustment expenses | | | 11,956,831 | |
| Loss adjustment expenses | | | 193,300,842 | (2) |
| Commissions payable, contingent commissions and other similar charges | | | 1,736,601 | |
| Other expenses | | | 13,584,519 | |
| Taxes, licenses and fees | | | 239,305 | |
| Unearned premiums | | | 59,063,223 | (2) |
| Advance premiums | | | 25,350,548 | |
| Policyholder dividends declared and unpaid | | | 14,961,442 | |
| Ceded reinsurance premiums payable | | | 5,083,174 | |
| Funds held by company under reinsurance treaties | | | 19,496,910 | |
| Amounts withheld or retained by company for account of others | | | 11,924,525 | |
| Remittances and items not allocated | | | 193,368 | |
| Provision for reinsurance | | | 36,099 | |
| Payable for securities | | | 73,009 | |
| Minimum pension liability | | | <u>8,388,465</u> | |
| Total liabilities | | | \$ 671,349,671 | |
| Surplus notes | | \$ 25,000,000 | | |
| Unassigned funds | | <u>363,943,949</u> | | |
| Surplus as regards policyholders | | | <u>388,943,949</u> | |
| Total liabilities, surplus and other funds | | | <u>\$1,060,293,620</u> | |

Underwriting and Investment Exhibit
for the Year Ended December 31, 2008

Statement of Income

Underwriting Income

| | |
|-----------------|----------------|
| Premiums earned | \$ 177,826,044 |
|-----------------|----------------|

Deductions:

| | |
|--------------------------------------|-------------------|
| Losses incurred | \$ 36,598,296 |
| Loss expenses incurred | 60,982,007 |
| Other underwriting expenses incurred | <u>38,866,552</u> |

| | |
|-------------------------------|--------------------|
| Total underwriting deductions | <u>136,446,855</u> |
|-------------------------------|--------------------|

| | |
|-----------------------|------------|
| Net underwriting gain | 41,379,189 |
|-----------------------|------------|

Investment Income

| | |
|------------------------------|---------------------|
| Net investment income earned | \$ 33,249,483 |
| Net realized capital loss | <u>(61,625,484)</u> |

| | |
|---------------------|--------------|
| Net investment loss | (28,376,001) |
|---------------------|--------------|

Other Income

| | |
|--|----------------|
| Aggregate write-ins for miscellaneous income | \$ (2,138,079) |
|--|----------------|

| | |
|--------------------|--------------------|
| Total other income | <u>(2,138,079)</u> |
|--------------------|--------------------|

| | |
|---|-------------------|
| Net income before dividends to policyholders and federal income taxes | 10,865,109 |
| Policyholder dividends | 14,030,026 |
| Federal income taxes incurred | <u>10,720,080</u> |

| | |
|----------|------------------------|
| Net loss | <u>\$ (13,884,997)</u> |
|----------|------------------------|

Capital and Surplus Account

| | |
|---|----------------|
| Surplus as regards policyholders, December 31, 2007 | \$ 441,523,617 |
|---|----------------|

| | |
|--|--------------------|
| Net loss | \$ (13,884,997) |
| Change in net unrealized capital gains or losses | (22,595,968) |
| Change in deferred income tax | 5,294,790 |
| Change in nonadmitted assets | (13,155,872) |
| Change in provision for reinsurance | 105,723 |
| Change in minimum pension liability | <u>(8,343,344)</u> |

| | |
|---|---------------------|
| Change in surplus as regards policyholders for the year | <u>(52,579,668)</u> |
|---|---------------------|

| | |
|---|-----------------------|
| Surplus as regards policyholders, December 31, 2008 | <u>\$ 388,943,949</u> |
|---|-----------------------|

Reconciliation of Surplus as Regards Policyholders
from December 31, 2004 through December 31, 2008

| | | | |
|--|-----------------------------|----------------------------|------------------------------|
| Surplus as regards policyholders, December 31, 2004, per Examination | | | \$ 311,626,029 |
| | <u>Gain in Surplus</u> | <u>Loss in Surplus</u> | |
| Net income | \$ 61,870,557 | \$ | |
| Change in net unrealized capital gains | 24,419,672 | | |
| Change in net deferred income tax | 10,108,661 | | |
| Change in nonadmitted assets | | 10,712,721 | |
| Change in provision for reinsurance | | 24,905 | |
| Change in surplus due to minimum pension liability | <u> </u> | <u>8,343,344</u> | |
| Totals | <u>\$ 96,398,890</u> | <u>\$ 19,080,970</u> | |
| Net increase in surplus as regards policyholders | | | <u>77,317,920</u> |
| Surplus as regards policyholders, December 31, 2008, per Examination | | | <u><u>\$ 388,943,949</u></u> |

COMMENTS ON FINANCIAL STATEMENT ITEMS

(1) Common Stocks

The Company was not in compliance with the National Association of Insurance Commissioners (NAIC) Practices and Procedures of the Securities Valuation Office Manual, Part 8, because it did not update the filings of its subsidiary investments annually. As of December 31, 2008, the total book value of all subsidiaries was \$169.3 million of which \$165.3 million was comprised of PMSLIC Insurance Company. No examination adjustment was made to the carrying values of the subsidiaries. It is recommended that the Company file its subsidiary investments annually in accordance with the NAIC Practices and Procedures of the Securities Valuation Office Manual, Part 8.

(2) Losses, Loss Adjustment Expenses, and Unearned Premiums

A Casualty Actuary from the California Department of Insurance reviewed the Statement of Actuarial Opinion and the actuarial reports prepared by the Company's actuaries and concurred that the Loss and Loss Adjustment Expense reserves and the reserve for Death, Disability and Retirement (DD&R) are reasonably stated as of December 31, 2008.

SUMMARY OF COMMENTS AND RECOMMENDATIONS

Current Report of Examination

Management and Control – Intercompany Agreements (Page 4): It is recommended that the Company amend its tax allocation agreement and file it with the California Department of Insurance pursuant to California Insurance Code Section 1215.5(b)(4).

Comments on Financial Statement Items – Common Stocks (Page 11): It is recommended that the Company file its subsidiary investments annually in accordance with the National

Association of Insurance Commissioners Practices and Procedures of the Securities Valuation Office Manual, Part 8.

Prior Report of Examination

None.

ACKNOWLEDGEMENT

Acknowledgment is made of the cooperation and assistance extended by the Company's officers and employees during the course of this examination.

Respectfully submitted,

/s/

Ber Vang, CFE, AES, CISA
Examiner-in-Charge
Senior Insurance Examiner (Specialist)
Department of Insurance
State of California